

## Summary & Analysis of USDA Outlook Forum

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Rich Feltes—Man Global Research—February 20, 2006

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**Conference Theme—Prospering in Rural America:** USDA Undersecretary Tom Dorr stressed the advantages of “*living locally and competing globally*” by outlining the benefits of residing in rural America including improved quality of life, increasing broad band connectivity and the handsome returns available to those willing to invest in bio-energy. Dorr noted enormous interest in US bio-energy by Middle-East investors at recent Renewable Energy Investor’s Forum. Dorr suggested making it easier for rural investors to invest in bio-energy plants that enhance both income and employment in rural America. USDA Secretary Johanns, in an effort to spark a new approach to existing farm policy, noted the many statements of appreciation at recent Farm Bill Listening Sessions regarding USDA’s rural development assistance programs. A recent Fed study found a negative correlation between the amount of farm subsidies rural counties receive and job and population growth. “*Farm payments appear to be linked with sub par economic and population growth*”. Johanns appealed to Congress to recognize the “*changing face of US Agriculture*” when deliberating the ’07 Farm Bill. It was quite apparent that the Administration will be encouraging rural residents who don’t receive subsidy checks to drive home point that large farm payments, which often end up in pockets of absentee landowners, are not in the best interests of rural America. Access to presentations by most of the 130 forum speakers is available at [www.usda.gov/oce/forum/2006\\_speeches.htm](http://www.usda.gov/oce/forum/2006_speeches.htm).

**USDA Chief Economist Keith Collins:** Collins anticipates a decline in ’06 US farm income amid large row crop stocks, livestock expansion, higher interest rates & energy costs and less favorable weather than last 2 years. ’06/07 global grain stocks will decline (he characterized world grain stocks/use as “*not excessive*”) while the ’05/06 world soybean stocks/use ratio is expected to exceed the high set in 1986. Collins looks for renewed weakness in soybean prices the 2<sup>nd</sup> half of ’06 and into ’07 if recent S. American crop estimates are realized. Regarding bio-fuels, Collins noted that by 2010 corn used for ethanol will comprise 22% of US corn use (vs. 14% for ’05/06) and that ethanol-not China-could be the primary factor driving corn prices over the next few years. Ethanol will supply 27% of the increase in US gasoline use over next 6 years. On the weather front, Collins noted dryness in central Midwest and southern plains and prospects for another active hurricane season. The ’06/07 outlook should be characterized by stable wheat prices, lower soybean prices and higher corn prices. And finally, Collins looks for a modest decline in ’06/07 farm income, higher farmland values and another cut in the US farm debt to asset ratio to the lowest level in 45 years. A complete copy of Dr. Collins’s remarks is available at; <http://www.usda.gov/oce/forum/2006%20Speeches/PDF%20speech%20docs/Collins-Speech.pdf>

**Reshaping US farm policy:** Former US Congressman Cal Dooley made a strong case for revamping US farm policy to comply with changing rural and global realities. He noted that 92% of US crop subsidies go to only 30% of US growers of 5 commodities that collectively comprise less than 30% of total US Ag revenue. Cash receipts from horticultural products alone in 2006 will be nearly equal to

cash receipts from the 5 program crops. He also noted enormous disconnect with market driven economics when farmers hope for low farm prices in order to maximize subsidy payouts. US sugar policy, in addition to inflating consumer prices, is driving US companies that use sugar rich products either off-shore or out of business. Dooley noted that reformed/market driven Ag policies in Australia & New Zealand have reinvigorated their agricultural economies and that unsubsidized US produce, meat and poultry markets are operating profitably without elaborate government programs. Dooley suggested reshaping US Ag policy into a safety net to manage revenue volatility via **Farm Savings Accounts** rather than maintaining existing transfer scheme from taxpayers to a relatively small number of farmers. He suggested that a collation of non-subsidy Ag recipients, environmentalists, representatives of rural America, CATO, US manufacturing and Ag researchers make a strong case that existing US farm policy is incompatible with today's competitive global agricultural environment. In short, Dooley encouraged farmers of the 5 major program crops to kick the subsidy habit by joining the 75% of US agriculture that is willing to compete and win in the global marketplace.

**Ag Trade Update:** An important topic given \$64.5 bil in US Ag exports representing production from 1 in 3 US cropland acres. Global Ag tariffs average 62% vs. average US tariffs for imported food of only 12%. US trade ambassador Robert Portman underscored multi-pronged approach to providing greater access to US Ag exports via multi-lateral, regional and bi-lateral trade agreements. Regrettably, multi lateral progress on the WTO is bogged down by the EU's refusal to reduce Ag import tariffs. EU intransigence has increased the number of bi-lateral initiatives which reduces the pressure for comprehensive multi-lateral reforms. Both Portman and USDA Undersecretary J.B. Penn emphasized the critical need to move forward with WTO negotiations prior to expiration of 7/07 Presidential Trade Promotional Authority which most observers believe has little chance for renewal. Speakers noted importance of moving forward with bi-lateral trade accord with S. Korea which is US's 7<sup>th</sup> largest trade partner and 10<sup>th</sup> largest economy globally. Bi-lateral US trade negotiations are also underway with 6 other nations. Farm groups calling for extension of present Farm Bill until successful conclusion of Doha round were termed "*disingenuous*" as they also don't want any Doha induced reduction in US farm subsidizes. USDA has restored nearly 2/3 of US beef exports shut down late in 2003 due to Mad Cow.

**Ethanol Update:** Sessions addressing ethanol were packed as attendees eagerly absorbed latest updates on "*the new bio-economy driven by a solar panel stretching from the Rockies to Appalachia*". CEO of John Deere referenced President Bush's statement last week that "*future Presidents will monitor crop reports regularly as good growing conditions will further reduce America's dependency on imported oil*". 50% of current US ethanol plants have substantial farmer ownership. Although the Corn Belt will be the primary region for new ethanol plant construction, ethanol plants are spreading outside the Midwest using potato peels in Washington, sugar cane in Hawaii and cheese waste in CA. Central NB could become a deficit corn market if all proposed ethanol projects are completed. Surging ethanol production capacity will increase the NB corn basis 10 cents/bu over the next 10 years. By August 2006, 3 bil gallons of ethanol will be produced in IA, MN, IL, NB & SD alone. Speakers recognized great potential in cellulose as the next major ethanol feedstock but enzyme technology is not competitive with low cost of converting corn to ethanol. US is world's top ethanol distiller with 4.26 bil gallons produced in '05 but Brazil is a close 2<sup>nd</sup> with '05 ethanol output of 4.22 bil gallons followed by China with 1.0 bil

gallons. Expansion of Midwest ethanol plants will undermine country elevator industry as producers continue to increase on farm storage and market directly to ethanol plants. One speaker indicated that some northwest IA ethanol plants, unable to merchandize DDG, are offering this ethanol by-product free to feeders and dumping excess onto fields. Given recent spike in natural gas prices (the 2<sup>nd</sup> largest input cost after corn in producing ethanol) some plants are looking at alternative energy sources like burning coal, corn syrup or manure.

**Brazil Update:** Brazil's net Ag exports in '05 topped \$37 bil vs. only \$12 bil in 2000. Soybeans, sugar and poultry are top Brazilian Ag exports in '05 at \$5.3, \$3.9 & \$3.5 bil dollars respectively. Growth of Brazilian processed food product exports is nearly as robust as bulk Ag products—a direct result of increasing foreign direct investment which has spurred domestic competition and lowered internal food prices. Look for continued strength in Real amid drastic cut in inflation, prospects for continued growth in exports of bulk and processed food, expectations for expansion in domestic food use as incomes improve (over 1/3 of Brazil's population-30 million—are low income) and a stable economic environment that will continue to attract more foreign direct investment. Cuts in Brazilian import tariffs and domestic taxes will come over time and be supportive to both Brazilian Ag competitiveness and the Real. Poor infrastructure, low level of public/private partnerships and high interest rates are limiting factors to more rapid growth in Brazil's Ag sector.

**Bio-Diesel:** Iowa expert on bio-diesel start-ups underscored the relative ease in attracting investor capital once location and financing requirements are fixed. USDA expects the 1.0 bil lbs of US soy oil to be used for bio-diesel in '05/06 to increase to 1.4 bil lbs in '06/07. The 53 existing US bio-diesel plants in US plus planned expansions and announced new plants over next 18 months would consume 4.74 bil lbs of oils/fats at full capacity or 20% of total US veg oil use in '04/05. 64% of existing US bio-diesel plants use soy-oil as the primary feedstock. EU continues to be global leader in bio fuels use with the goal of replacing 5.75% of transportation fuels with biofuels by 2010. Bio-diesel is by far the largest EU biofuel with nearly 5.9 mmt of veg oils used for industrial purposes in 05/06—over twice the amount used for food use. Bio-diesel expert noted that each ton of DDG displaces 0.4 tons of soy meal thus increasing availability of DDG, in addition to ever larger US crush rate to supply increasing bio-diesel needs, will pressure US meal prices and potentially turn US into major soy meal exporter. Regarding more efficient sources for bio-diesel, palm oil is the clear leader as it yields 3.9 mt/ha vs. 1.34 mt/ha for canola and only 0.55 mt/ha for soy oil. And finally, the bio-diesel boom is occurring at a time when the '05/06 global veg oil stocks to use ratio is the lowest since '73/74.

**Asian Poultry Update:** Primary drivers of growth in Asian poultry demand are GDP and outcome of bird flu epidemic. Most recent global data available from 2004 pegs total Asian poultry production at 21 mmt (31% of world production) vs. US poultry production of 16 mmt. 2006 Asian economic growth is expected to moderate only nominally from 2005 to 5.5% which suggests 3% growth in total '06 Asian meat demand—virtually unchanged from '05. Expert expressed view that worst of bird flu epidemic will have passed by mid 2007 although disease may become endemic in the poorest Asian countries where lack of refrigeration and sales of live chickens stifle efforts to control bird flu. Globally, poultry constitutes 16% of total coarse grain use and 25% of total oil meal use. FAO expects full recover in Asian poultry production by 2008. Bird flu in China has essentially stalled out poultry production at 10

mmt/annually since 2003 although resumption in strong uptrend in PRC poultry production is expected from 2007 onward. Bottom line—look for acceleration in Asian corn and meal use (suggesting greater US corn exports to Asia) once bird flu is under control.

**Grain/Soybean Outlook:** USDA's initial forecasts for '06/07 US grain and soybean supply/demand suggest going long corn against shorts in soybeans and wheat. Key variables to monitor in the weeks ahead that could alter USDA expectations for '07 US CN/BN/WHT ending stocks of 1.726/0.560/0.543 bil bu respectively include; a) extent of follow-through on KC wheat rally (attracting HRS acreage from soybeans), b) spring planting conditions (characterized by USDA as exceptionally good in 2005), c) summer weather conditions (a repeat of above trend row crop yields of last 2 years viewed as unlikely by USDA) and d) magnitude on '06/07 US soybean exports (US soybeans must be competitively priced with S. American soybeans to preclude further gains in 9/07 US soybean stocks.) Long term, USDA believes US wheat acres will continue to decline on heels of increasing oilseed acreage. Declining US wheat export market share portends changing role for domestic wheat price discovery with class shortages, when they occur, sending strong signal to importers to shop elsewhere after domestic millers bid up cash supplies. USDA pegs 10/07 US soy oil stocks at 2.4 bil lbs—down only nominally from 10/06 stocks despite 425 mil increase in '06/07 US soy oil use. USDA looks for continued expansion in PRC soybean imports to meet steady increase in domestic soy meal usage. USDA's forecasts a record 550 mil bu increase in '06/07 US corn used for ethanol—clearly in harmony with optimistic tone struck by varied ethanol presenters throughout the week. On the yield front, we think their '06 US corn yield of 147.7 BPA looks conservative while their soybean yield of 40.7 BPA appears reasonable given reduced fear from rust and surprising performance of '05 US soybean yield. The '06 US wheat yield will depend heavily on timing and quantity of spring rains across the plains.

**Tid Bits:** Wal Mart, which employs 1.3 mil Americans, saves US families that shop there \$2300 annually. More than 138 mil Americans shop at Wal Mart weekly.

Global population will grow from 6 to 8.5 bil over next 30 years—almost entirely in the developing world where half of the world's population lives on less than \$2.00/day. Opening up free trade to these economies is vital to expanding US Ag exports as 30 cents of each additional dollar of developing world income goes to food.

PRC meat consumption has risen over 10% annually over the last decade.

Trucker making US cross country trip with 20% bio diesel blend would use 645 lbs of veg oil which is the equivalent of veg oil consumed by 25 people in India per year.

New wind turbines today produce 3 times the returns of turbines constructed just 4 years ago. Unlike investments in bio-fuel projects, returns on wind turbines are regarded as annuities.

Several representatives from KS indicated that their '06 wheat yield prospects are still trend or higher given timely spring rainfall.

## Man Global Research

The value of '04/05 PRC Ag imports was more than double the value of 2002 food imports. Feeding the Chinese dragon will become a more important factor in world Ag trade during the 21<sup>st</sup> century.

Research on drought tolerant corn varieties continues with new hybrids using less water, producing higher yields and reducing aflatoxin contamination.

Don't look for any breakout of index fund net positions on the weekly CFTC activity report for at least 6 months.

**Wrap Up:** Aside from a fleeting reference by Dr. Collins to Index funds, this year's unusually strong line-up of speakers on timely topics relevant to American agriculture avoided any mention of surge in investor capital responsible for pushing up ag commodity open interest and prices. The excitement and interest in bio-energy was overwhelming with no one daring to discuss implications of either much higher corn prices or much lower crude oil prices on growth or profitability in the ethanol industry. President of National corn growers rebuked question on likely winner of "fuel vs. food" battle if corn prices soar but seasoned economists in attendance know if supplies are tight that stomachs will trump fuel tanks. Index fund managers listening to Collins and others at this conference emerged with view that corn will be the upside price leader in the year ahead. Hopes for resolution of bird flu problem next year and steady shrinkage in PRC corn stocks provide additional fodder for index funds to extend their ownership in new crop corn. Soybeans are being swept along on the upside amid strength in grains but oilseed fundamentals are clearly negative. USDA forecasts for '06/07 soy oil prices of only 20 cents/lb suggests that bio-energy price boom in soy-oil is not imminent. Overpriced US wheat market relative to competitors will eventually topple wheat bull but not until southern plains weather pattern suggests return to normal rains. Looking ahead, advise reacting to '06 events as they unfold. Pay particular attention to how record index fund participation may exaggerate price moves. Unforeseen '05 market developments, as outlined by Dr. Collins, included record US hurricane devastation, intensification of bird flu, false alarm on soybean rust, surging energy prices and much higher than expected '05 US row crop yields despite an unusually warm summer. **"Successful traders base no moves on what supposedly will happen but react instead to what does happen."** Our hunch is that negative fundamentals in soybeans will have more traction after '06 US crop is planted but until then, drought worries in US wheat and bullish bio-energy story are more than enough to draw additional index capital into grains.